

**Statement of the Investment Company Institute  
United States House of Representatives Committee on Ways and Means  
United States Senate Committee on Finance  
Joint Hearing on  
Tax Reform and the Tax Treatment of Capital Gains**

**September 20, 2012**

The Investment Company Institute<sup>1</sup> appreciates the opportunity to provide comments to the House Committee on Ways and Means and the Senate Committee on Finance on the tax treatment of capital gains. The Institute urges the Congress to extend permanently the current tax rates on capital gains and dividends. Maintaining these rates, the Institute believes, will encourage savings and foster economic growth.

As the Committees are aware, current tax rates on ordinary income, dividends, and capital gains are scheduled to expire on January 1, 2013. These impending changes have significant implications for mutual fund shareholders. Currently, the top federal tax rate on both capital gains and dividends is 15 percent. Unless Congress acts, the top federal tax rate on capital gains will increase to 20 percent, and dividends will be taxed as ordinary income, resulting in a maximum federal tax rate of 39.6 percent.<sup>2</sup> In addition, beginning in 2013, both capital gains and dividends will be subject to an additional 3.8 percent tax dedicated to funding Medicare. Furthermore, the 2013 scheduled restoration of the "Pease limitation" on itemized deductions could impose an additional tax of roughly 1.2 percent on capital gains and dividend income. Not only would these changes increase taxes for millions of mutual fund investors, they likely would be a drag on economic growth.

**Capital Gains and Dividend Income are Subject to Double Taxation**

Individual shareholders of a corporation own the firm and the profits that are generated. Under the U.S. income tax, these profits are taxed twice: once at the corporate level and again when received as income by shareholders, either as dividend payments or as capital gains attributable to retained earnings. As discussed below, such double taxation reduces economic efficiency and undermines long-term growth.

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<sup>1</sup> The Investment Company Institute is the national association of U.S. investment companies, including mutual funds, closed-end funds, exchange-traded funds (ETFs), and unit investment trusts (UITs). ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of funds, their shareholders, directors, and advisers. Members of ICI manage total assets of \$13.5 trillion and serve over 90 million shareholders.

<sup>2</sup> The current top tax rate for ordinary income is 35 percent, but this rate also is set to revert back the higher rate of 39.6 percent in 2013.

The current maximum tax rate on corporations is 35 percent. If a corporation's profits are distributed to shareholders in the form of dividends, they are taxed a second time, at the rate applicable to each shareholder. If the profits are retained, they are later reflected in the value of the stock when sold. Those profits similarly are taxed a second time, at the capital gains rate applicable to each shareholder.

In the mutual fund context, a regulated investment company, or "RIC," is not taxed at the fund level so long as the fund distributes all of its net capital gains and income to shareholders. The dividends and short-term capital gains that a fund receives and then distributes to its shareholders are subject to tax at the shareholders' applicable rates. Similarly, the long-term capital gains that a fund receives and distributes are taxable to the fund shareholders as long-term capital gains. Thus, corporate profits still are subject to double taxation when they flow through a mutual fund to the fund's shareholders.

In 2003, Congress lowered tax rates on dividends and capital gains to help reduce the harmful impacts of double taxation. The top federal tax rate on capital gains was reduced from 20 percent to 15 percent, and the top rate on "qualified dividend income" was reduced from the top ordinary income tax rate of 39.6 percent to 15 percent. Importantly, this change in law also harmonized the treatment of dividends with that of capital gains.

Even with the current top rate of 15 percent on dividends and capital gains, the combined federal tax rate on corporate profits can be as high as 45 percent. If the current rates are not extended, the combined federal tax rates would be substantially higher. The top federal tax rate on capital gains would increase to 20 percent, and dividends would be taxed as ordinary income at a maximum marginal rate of 39.6 percent. Furthermore, the 2013 scheduled restoration of the "Pease limitation" on itemized deductions could impose an additional tax of roughly 1.2 percent on capital gains and dividend income. In addition, beginning in 2013, investors will be subject to the new 3.8 percent Medicare tax on investment income enacted as part of the Patient Protection and Affordable Care Act of 2010. This means that, absent Congressional action, the federal individual income tax rate on capital gains could be as high as 25 percent, and the federal individual income tax rate on dividends could be as high as 44.6 percent. All together, these changes would lead to a combined federal tax rate (inclusive of both corporate and individual income taxes) as high as 51.25 percent on capital gains and 63.99 percent on dividends.

Even without these pending rate increases, the United States' integrated tax rate on corporate profits – meaning the combined federal, state and local taxes on corporations and capital gains and dividends – is higher than most all other industrialized nations, including both the G-7 and members of the Organisation for Economic Cooperation and Development (OECD).<sup>3</sup> This high level of double taxation on corporate profits thus raises real concerns about the United States' ability to compete internationally for investment.

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<sup>3</sup> See Robert Carroll, "The Economic Effects of the Lower Tax Rate on Dividends," *Tax Foundation Special Report*, no. 181, June 2010, p. 10, Table 3.

## Impact on Economic Growth

Because of the double taxation on corporate profits, income derived from owning corporate stock is taxed at rates far in excess of the tax imposed on other investments. This treatment causes investment decisions to be made on the basis of tax treatment rather than market fundamentals and, in doing so, reduces economic efficiency.<sup>4</sup>

For example, taxing dividends more heavily than capital gains discourages corporations from distributing profits as dividends, as opposed to retaining the profits within the company or distributing the profits by repurchasing shares. Reducing the amount of profits that are retained within the firm increases the pressure on corporate managers to undertake only the most productive investments.

Double taxation also encourages the use of debt financing rather than equity financing because corporate interest expenses are deductible, but dividend payments are not. Firms with excessive debt are more vulnerable during economic downturns.

Further, taxing corporate profits twice discourages investment in the corporate sector and encourages less productive investment in sectors not subject to the double tax – that is, investments in real estate and the noncorporate sector, such as partnerships and limited liability companies.

Raising tax rates on capital gains and dividends will exacerbate the effects of double taxation and undermine long-term growth. Many of the beneficial effects of reducing the double tax on corporations – such as the shifting of more investment into the corporate sector or a shift away from debt finance toward equity finance – only will be realized in the long run. There already is evidence, however, to suggest that corporations have responded to the reduction in the dividend tax rate by increasing dividend payouts.

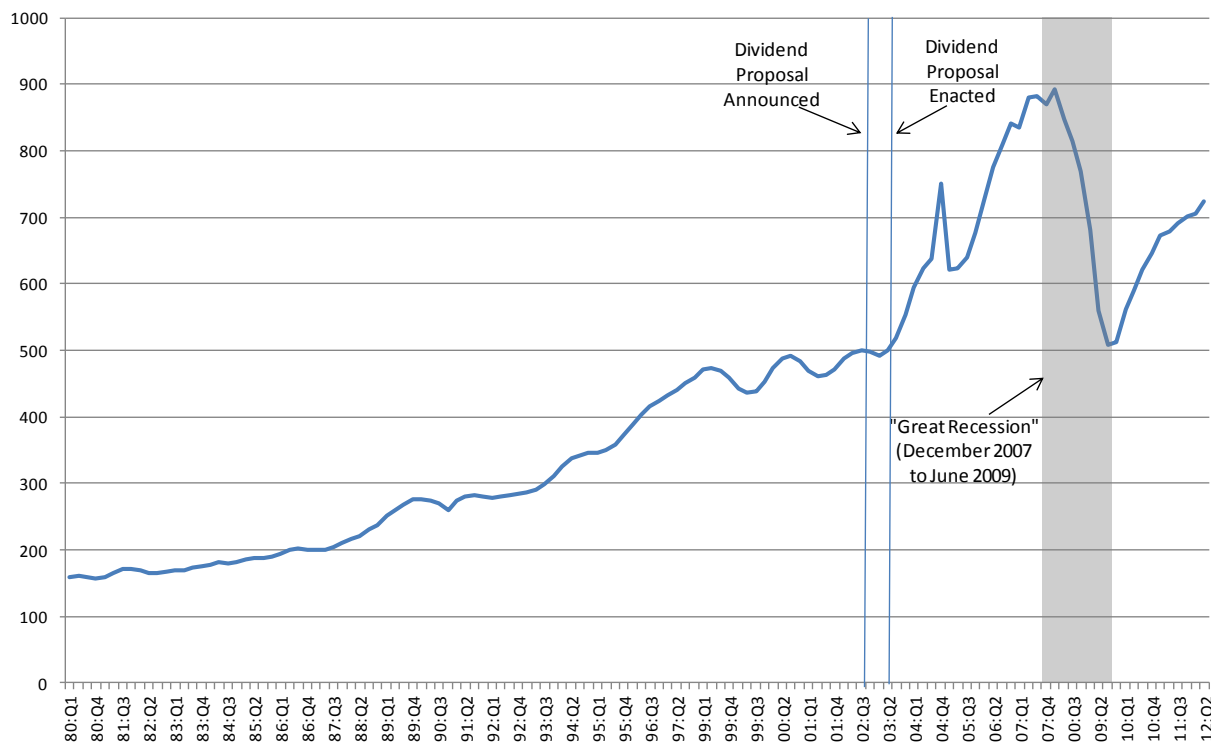
The attached chart plots personal dividend income from the National Income and Product Accounts (NIPA). The aggregate data show an increase in dividend payments that begins in the third quarter of 2003, immediately following the enactment of the lower tax rate on dividends. In the two years following the tax cut (mid-year 2003 to mid-year 2005), aggregate dividend payments were 26 percent higher than in the two years prior to the tax cut (mid-year 2001 to mid-year 2003). Dividend payments declined during the “great recession” (December 2007 to June 2009), but have recovered rapidly in recent years. For example, in the second quarter of 2012, dividend payments were 45 percent higher than in the second quarter of 2003, adjusted for inflation.

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<sup>4</sup> For an in-depth explanation of the beneficial economic effects of reducing the double tax on corporate profits, *see id.*

## NIPA Personal Dividend Income, 1980:Q1 to 2012:Q2

Quarterly data, billions of 2012 dollars, seasonally adjusted at annual rates



Source: U.S. Department of Commerce, Bureau of Economic Analysis

Although these data are suggestive, caution with regard to conclusions drawn from aggregate data is warranted for a number of reasons. For example, it is hard to disentangle the effect of taxes from the effect of other factors, such as the business cycle. Also, a relatively small number of large corporations account for a large proportion of total dividends paid, and the aggregate data include special dividend payments, which tend to be more volatile than regular dividend payments.<sup>5</sup> Finally, the data often are revised as more complete data are collected.

More convincing evidence on the effect of the cut in dividend rates comes from a series of academic papers that use firm level data which allow the authors to examine the behavior of individual firms over time.<sup>6</sup> Using data on approximately 5,000 publicly traded firms, the

<sup>5</sup>For example, the spike in dividend income in the fourth quarter of 2004 is due to a \$32 billion (\$128 billion at an annual rate) special dividend paid by Microsoft.

<sup>6</sup>Raj Chetty and Emmanuel Saez, "Dividend Taxes and Corporate Behavior: Evidence from the 2003 Dividend Tax Cut," *Quarterly Journal of Economics*, vol. 120, no. 3, 791-833, 2005; Raj Chetty and Emmanuel Saez, "The Effects of the 2003 Dividend Tax Cut on Corporate Behavior: Interpreting the Evidence," *American Economic Review Papers and Proceedings*, vol. 96, no. 2, 2006; and Raj Chetty and Emmanuel Saez, "Dividend and Corporate Taxation in an Agency Model of the Firm," *American Economic Journal: Economic Policy*, forthcoming.

authors show that the number of firms initiating regular dividend payments spiked after the tax cut, and many firms that were already paying regular dividends increased payments substantially.<sup>7</sup> These results hold even when the authors control for other factors, such as profits. The authors also find evidence consistent with the hypothesis that lower dividend taxes improve the allocation of capital. For example, firms with lower expected earnings growth were more likely to increase dividend payments than were firms with higher expected earnings growth (which presumably had more productive uses for retained earnings).

The Congress should pass legislation that encourages growth, particularly as the United States continues to face challenging economic conditions. Therefore, it is critical that the Congress extend the current federal tax rates on capital gains and dividends.

### **Permanent, not Temporary, Extension**

The 2003 tax cuts for capital gains and dividends originally were set to expire in 2011. After much discussion and political negotiation over whether and the extent to which such rates would be extended, the Congress extended the current rates for two more years, through the end of 2012. This level of uncertainty and the temporary nature of certain tax benefits can affect the behavior of corporations and investors. It thus is imperative that the Congress provide certainty to corporations and investors, again permitting them to make decisions based on market fundamentals rather than tax consequences. Also, the benefits of reducing the double taxation on corporate profits can take some time to materialize, and temporary fixes may not fully allow for this to occur. Therefore, the Institute urges the Congress to extend the current rates permanently.

### **Conclusion**

The Institute urges the Congress to extend permanently the current tax rates on capital gains and dividends. The Institute believes that retaining the current rates would encourage savings and foster economic growth. We believe that, at a minimum, taxes imposed on qualified dividends and capital gains should not be increased, especially when our economy remains so fragile.

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<sup>7</sup> Changes to regular dividend payments are considered more significant than special dividend payments, as firms appear reluctant to reduce regular dividend payments once they are established.